An excerpt from:
iNews
Winter 2007
Issue 1

The Status of Fair Value Accounting

By: Brock Benson[*] and Mussie Teclezion[**], iComp LLC.
Jan 5th 2007

In September of 2006, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 157, *Fair Value Measurement* (FAS 157). This regulation solidifies the definition of fair value to be applied within the scope of current generally accepted accounting principles (GAAP). The FASB believes that this consolidated definition of fair value will improve the information content and comparability of financial statements, when it becomes effective after November 15, 2007.[1] In addition, they hope to bring GAAP accounting rules into better alignment with international rules, which already call for fair value accounting (IAS 39, *Financial Instruments: Recognition and Measurement).*

It appears, on the surface, that FAS 157 will not dramatically impact the methods in which firms report financial information, given that it does not propose any new instances of fair value measurement. However, with the increased use of fair value accounting in current standards[2], FAS 157 will, ultimately, have a significant impact upon the reporting requirements of firms. Whether or not this results in a marked increase in the informational content of their financials is to be seen.

Understanding the Accounting Changes

The primary impact of FAS 157 will be through its consolidated definition of fair value. FAS 157 clarifies that fair value, in its purest since, is a market-based measure, as opposed to an entity specific measure. Although FAS 157 gives highest priority to market based prices, it does set forth a fair value hierarchy based on the level of inputs used to determine the value of an asset or liability.

The FASB breaks this hierarchy of fair value down into three basic levels. As defined in FAS 157, Level 1 inputs are ***quoted prices in active markets for identical assets or liabilities***. Level 2 inputs are inputs other than quoted prices included in Level 1 – ***prices for similar assets/liabilities, pricing on identical assets within inactive markets, etc***. Level 3 inputs are ***unobservable inputs for the asset or liability***. These unobservable inputs should reflect the reporting entity's assumptions about market participants. Assets or liabilities requiring Level 3 inputs must be valued through ***a combination of income, market, and cost approaches.***

Regardless of the hierarchy of fair value applied, valuation techniques should be consistent, and revision of fair value resulting from a change in valuation technique, or its

---

[*] Brock Benson is the founding partner of iComp LLC.
[**] Mussie Teclezion is a partner of iComp LLC.
[1] For firms with non-calendar year physical years. For calendar year end firms it becomes effective in 2008.
[2] Such as, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments.*

application, will constitute a change in the accounting method as defined under FASB statement No. 154, *Accounting Changes and Error Corrections*.

In addition to determining fair value, FAS 157 places extensive disclosure requirements on assets and liabilities measured under fair value. It requires separate disclosure for items that are measured on both a recurring basis (i.e. investment securities), and non-recurring basis (i.e. impaired assets). Fair value measurements obtained using significant unobservable inputs (Level 3) require a reconciliation of the beginning and ending balances of total gains and losses for the period to be disclosed. Any purchases, sales, issuances or settlements of assets (liabilities) in this class must also be fully disclosed according to the regulation. Additionally, assets or liabilities transferring in or out of Level 3 status must be disclosed in detail. [3]

Finally, the regulation calls for retrospective treatment, at the time of its initial adoption, for financial instruments using a blockage factor, instruments previously measured using transaction prices under FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and hybrid financial instruments measured via transaction prices under FAS 155, *Accounting for Certain Hybrid Financial Instruments*.

What Will the Impact Be?

There is no doubt that FAS 157 has the “potential” to cause substantial change in the information reported by firms. Again, the question of whether or not the information content of financial statements will improve is to be determined. The FASB believes it will, but the market should be skeptical for several reasons.

Net Income Impacts

Because FAS 157 calls for “mark-to-market[4]” valuation of assets valued on a recurring basis, with any gains and losses included in net income (loss), there is the potential for significant increases in period-over-period net income volatility. In addition, the FASB has proposed allowing firms the one-time option to adopt for specific financial instruments already on the balance sheet, with the results of these accounting changes also included in current earnings.

Recent Guidance: During the January 3rd FASB meeting on fair value options, a plan was proposed to allow firms to achieve an offset accounting effect, without having to apply complex hedging accounting, for the changes in fair values of assets and liabilities.

---

[3] Recent guidance on Jan 3rd, 2007 will dramatically lower these reporting requirements. This is discussed later on in this article.

[4] “Mark-to-market” involves revaluing the asset/liability at regular intervals, typically annually, over the period in which the asset or liability is held by the firm.

Selective Adoption and Selection Bias

Under its current implementation, FAS 157 allows management to selectively choose those assets and liabilities to which they want to apply the new definition of fair value. This discretion will ultimately lead to management selecting those assets (liabilities) which they believe will increase (decrease) in value over time, thus creating a positive (non-cash) impact on earnings. We expect that this selection bias will exist across various asset classes and industries over time.

Recent Guidance: The FASB arrived at the tentative decision to require, if the proposal is adopted, all investments currently recognized under the equity method to be reported at fair value, rather than fair value election on a contract-by-contract basis. However, for all other assets and liabilities adoption continues to be on a contract-by-contract basis.

Inconsistent Valuation Methodology

A consensus methodology for valuing assets (liabilities) requiring Level 2 or 3 inputs has currently not been reached. Thus, the valuation of intangible assets (i.e. patents, in-process R&D, etc.), derivative instruments, and interests in private firms will likely be performed inconsistently from one firm to the next. This will lead to less comparability across financial statements and firms across time.

Recent Guidance: The FASB recently withdrew its previous decision to require an entity to disclose the methods and significant assumptions used to estimate the fair value of assets and liabilities for which the FVO (fair value option) has been applied and Level 3 inputs were used. This additional disclosure is vital to ensuring comparability across asset and liability classes, thus we hope it is reinstated before the regulation becomes final.

Earnings Management

The additional levels of discretion allotted management under this regulation, in the presence of limited valuation guidance, will, ultimately, increase their ability to manage earnings over time. This ability will increase directly with the proportion of Level 2 and Level 3 assets (liabilities) held by the firm.

Recent Guidance has done little to stem the ability of management to manipulate earnings. In fact, with the continued ability to select those assets and liabilities to which fair value accounting will be applied and the softening of the reporting requirements for assets and liabilities using Level 3 inputs, management is in a better position than ever to fiddle with earnings if so desired.

In the End

The FASB believes that FAS 157, and related fair value accounting regulations, has the potential to dramatically increase the informational content of financial statements. The increases in net income volatility, the selective adoption of assets and liabilities by firms, the inconsistent methodology employed, and the increase in the ability to manage earnings place serious limitations on any potential positive impacts of this regulation. In addition, the tone of the FASB's most recent "Fair Value Options Project[5]" meeting has done little to give hope that fair value accounting will result in its intended goal – comparable, representative financial statements. However, we will just have to wait and see once the final guidance is issued later this year.

Upcoming on the Calendar for Fair Value Accounting

The FASB will be releasing Phase 1 of its fair value guidance in the first quarter of this year. It will cover the application of fair value for financial assets and liabilities. We will certainly keep you informed with a detailed review of the document upon its release.

Phase 2 of the FASB's guidance, which will cover selected nonfinancial items, should not be expected before July of this year, with likely release towards the end of 2007. We will keep you aware of its progress, with timely review as soon as it's released.

No additional guidance is plated for release after Phase 2, but if history serves us well, we should expect continued comments as the FASB moves forward on its pursuit of fair value accounting.

If you have any questions or comments about any of the information contained in this, or any other article in this addition of iNews, please contact us at:

***i*Comp LLC.**
10565 N 114th Street, Suite 109.
Scottsdale, AZ 85259
(480) 850-9700
www.integratedcompensation.com
info@integratedcompensation.com

Brock Benson
Founding Partner
(480) 656-4243 (direct)
brock.benson@integratedcompensation.com

[5] The most recent meeting as of the date of this article was Jan 3rd 2007